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## Treasury Finalizes Debt-for-Equity Regs With Implied Circular Flow of Cash



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Summary by **taxanalysts®**

Final debt-for-equity regulations under section 108(e)(8) released November 15 do not allow a debt-for-equity exchange to be bifurcated so that the creditor can recognize a loss or a bad debt deduction as part of the exchange but do provide a partial section 721 carveout.

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The Treasury Department on November 15 released final debt-for-equity regulations under section 108(e)(8) that maintain a section 721 approach and do not allow a debt-for-equity exchange to be bifurcated so that the creditor can recognize a loss or a bad debt deduction as part of the exchange. However, they provide a carveout from section 721 when partnership equity is used to pay for interest and some ordinary income items.





"Practitioners were concerned that if section 721 did not apply, the partnership could recognize tax if the partnership were viewed as an aggregate and deemed to transfer a pro rata portion of its underlying assets to satisfy the creditor obligation," said Steven R. Schneider, a director at Goulston & Storrs. "The final regulations put that fear to rest and provide that the partnership will not recognize gain or loss upon the transfer of equity to a creditor for unpaid rent, royalties, or interest." (For the final regs (T.D. 9557), see *Doc 2011-23977*  .)

Bob Crnkovich, former senior counsel (partnerships) in Treasury's Office of Tax Legislative Counsel, was involved in drafting the guidance while he was at Treasury. "This could be viewed as creating an implicit circular flow of cash from the debtor's standpoint," said Crnkovich, now a partner in the joint venture and partnerships tax services group at Ernst & Young LLP's National Tax Department. "That's exactly what was intended."

Phillip Gall, a co-managing principal of the passthroughs group in Deloitte Tax LLP's National Tax office, added that the effect of the section 721 approach is that if a creditor hadn't picked up items of ordinary income, it couldn't defer and convert the ultimate pick-up into capital gain by simply contributing those items (such as unpaid interest on debt) to a partnership in a debt-for-equity exchange.

### Basic Rules

The section 108(e)(8) final regulations provide that when a party transfers its creditor position to the debtor partnership in exchange for an equity interest in the partnership, it realizes no gain or loss, and the partnership realizes cancellation of indebtedness (COD) income equal to the difference between the debt and the value of the interest received.

The regs contain a liquidation value safe harbor that treats the fair market value of the partnership interest transferred to the creditor as the liquidation value of the partnership interest if four requirements are met. (For prior coverage, see *Doc 2011-23657*  or *2011 TNT 218-4* . For the proposed regs (REG-164370-05), see *Doc 2008-23074*  or *2008 TNT 212-10* .)

The final regs make only slight modifications to the proposed rules. Among other things, the final regs:

- remove the capital account maintenance requirement from the liquidation value safe harbor because it isn't necessary to determine the liquidation value;
- require that a partnership and all its partners apply a consistent valuation methodology so that differences between liquidation value and FMV can't be used to whipsaw the government;
- clarify that the safe harbor's arm's-length requirement can be satisfied among related parties;
- limit the scope of the section 721 exception for unpaid rent, royalties, and interest so that it applies only to items that accrue after the creditor acquired the loan; and
- include a partnership's COD income in the first tier of a minimum gain chargeback under section 704.

### **Interest-First Ordering Rule**

While the implied circular flow of cash has the potential to allow a creditor to take a bad debt deduction for any unpaid interest, the opportunity to take advantage of that rule is greatly diminished by the interest-first ordering rule in the final regulations.

Practitioners have argued that in a debt workout situation, it isn't appropriate to assign the payment first against interest, as opposed to principal, but under reg. section 1.721-1(d)(3), taxpayers are directed to rely on the interest-first ordering rules of reg. sections 1.446-2 and 1.1275-2.

"We felt that this project was not the appropriate forum to take on the reg. section 1.446-2 ordering rule," Crnkovich said. "We understand the objections. That's an income tax and accounting issue."

### **Valuation Games**

The preamble to the final regulations contains a cryptic cite to the payment for services

rules of section 707(a)(2)(A) in connection with discrepancies between the FMV of the debt-for-equity interest and the FMV of the indebtedness exchanged.

"We wanted to be clear that if you play games with valuations, there is another code provision -- section 707(a)(2)(A) -- that could come into play," Crnkovich clarified. "It's another arrow in the IRS's quiver."

### **Alternative to Bifurcation**

Although the government decided that allowing taxpayers to bifurcate debt-for-equity exchanges in the context of partnerships would be inconsistent with the treatment provided to corporations engaging in similar transactions, the preamble to the final regulations indicates that it's possible for a creditor to take a bad debt deduction, as long as it's done prior to the debt-for-equity exchange under section 166.

"We wanted to signal that if you have a valid pre-contribution write-off that's not stepped together, that's one way to achieve" a similar result, Crnkovich said.

However, Schneider said the rule in section 166 has limited application. "Section 166(d) disallows partial worthlessness deductions for noncorporate lenders not in the trade or business of lending, which is often the case with partner loans or certain mezzanine loans," he said. "For these lenders, the excess basis gets trapped in their outside basis in the partnership since the underlying section 704(c) built-in loss asset is the loan, which disappears as part of the transaction."

Schneider said that, in essence, if a taxpayer is not a bank, it should think twice before contributing debt for equity.

### **Tax Analysts Information**

**Code Sections:** Section 108 -- Discharge of Indebtedness  
Section 721 -- Contribution to Partnership  
Section 722 -- Contributing Partner's Basis  
Section 704 -- Partner's Distributive Share  
Section 1223 -- Holding Period  
Section 1275 -- OID Definitions  
Section 446 -- Methods of Accounting  
Section 166 -- Bad Debts

**Jurisdiction:** United States

**Subject Areas:** Accounting periods and methods  
Partnership taxation  
Compliance  
Corporate taxation  
Tax system administration issues  
Bankruptcy and insolvency

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